Weekly Overview

ISSN 2253-3672

29 May 2014

Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz

2014 Themes

- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up
- House prices will rise with gains spreading out of ChCh and Auckland
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies
- Business capital spending will grow
- Household spending growth will accelerate

Population Targeting

For me the most interesting piece of news in our economic sphere this week was the release of a report from PWC regarding business confidence and attitudes toward the labour market. Based upon a survey of 48 NZ businesses included among a global survey of 1,344 they found Kiwi firms to have above average confidence about their own and their economy's performance in the coming year. Approximately 69% expected their revenues to rise compared with 39% globally. Nothing too surprising there.

The interesting bit however was that about 80% said shortage of skills was a serious concern versus 63% globally. All bar five of the NZ firms said they need to change strategies for attracting and retaining staff. Yet few had actually done anything about it.

What this highlights is a vulnerability which the NZ business community already has to the changes in the country's labour market. Firstly there is the simple cyclical change as growth in the economy accelerates and labour demand picks up. Second there is the fact that this "cycle" in the economy is likely to include a more drawn out period of strong growth than usual related to construction and infrastructure.

Third there are the demographic changes underway. The most important one is the slowing in the pace of growth of the labour force from near 30% in the decade and a half before 2011 to just under 20% projected for the decade and a half after. The current migration boom generated by Kiwis - shock horror - not flooding overseas and providing Opposition parties in Parliament with brain drain stories, will provide some relief. But it pays to remember a very important thing. There is a cycle in the population flows between NZ and Australia.

The cycle was due to turn about a year and a half ago. It has turned. The turning is more sharp than expected due to short to medium term divergent paths for the NZ and Australian economies. But Australia has a solid economic base while ours is more fragile and highly vulnerable to hubris with regard to dairying. Therefore the cycle will eventually turn back again.

That raises a very important point which those thinking about tinkering with migration policy to influence inflation should take on board. Firstly, history shows that when a government uses fiscal policy to try and smooth the economic cycle the outcome is usually a worsening of the cycle. That is because by the time the need for policy change is recognised, decided, implemented, then becomes effective, the cycle has usually turned anyway. So upsides are exacerbated and downturns worsened. One suspects the same outcome were our migration policy altered to try to influence the economic cycle, though with the extra negative of painting NZ in the minds of potential migrants as an unreliable destination liable to shut the doors at any time, even if one has spent a year going through various pre-moving steps. Actually that would probably just cause our perceived attitude toward migrants to match our actual attitude toward foreign capital. Unwelcoming.

Ultimately what policy proposers need to understand is that just because you believe changing thing X will have some influence on thing Y does not mean you actually have information on the magnitude or timing of the links, and you almost certainly won't have information on the externalities, the unintended consequences. And when it comes to migration policy it pays to note that before you have one you first of all need to develop a population policy.

Therefore anyone who may feel attracted to the idea of trying to control house prices by tinkering with migration rules first needs to demand of the policy proposers what their underlying population policy is. In particular, if they have some desired rate of population growth in mind, how does it manifest itself in terms of desired rates of growth in the various population groups - Asian, Maori, Pacifica, European descendants etc. and one must also give thought to the regional component of one's population policy. See why no-one has a population policy? Icky.

Targeting the housing market by trying to alter migration flows is well down on the list of things which can usefully be done to try and make housing more affordable over the long run in New Zealand. Three quarters of migrants going in and out are us, we need migrants due to the labour market tightening and the business sector not adjusting to it, yet globally we don't really rank all that highly on the list of places which skilled and motivated migrants want to go to. Our ability to pick and choose is not what we think - again, the weakness of hubris.

Key parts of the solution to housing affordability could include removing residential and rural land designations, buyers choosing standardised designs from rather than individually architecturally designed abodes, councils abolishing development and infrastructure fees and placing costs back on the existing rate paying base, reducing construction standards with regard to insulation, earthquake preparedness etc., banning developers from imposing rules for houses built in their new subdivisions, removing restrictions on placement of multi-storey buildings. See why affordability won't improve much if ever from current levels? Most of these things are complete non-goers which I personally would not support. But they would have a far greater sustained impact than restricting foreigners buying houses, though I do support that policy and think at least getting a register of which folk offshore are buying our homes would be a useful and logical thing to do.

Given the style of houses we like, the ways we like to live, the multitudinous rules and restrictions, the many construction costs as everyone clips the ticket along the way, and the existing shortage of houses in our two biggest cities accounting for almost half our population, house prices rise.

Oh, and to finish with, last week I noted how 18 months ago I warned that with house prices having risen so much during a period of below average migration flows, one should imagine what would happen when those flows turned upward, as they have now done. Now lets add a new item in the same vein.

House prices have risen firmly during an extended period of minimal wage and salary growth for a great number of people. Imagine what will happen from now on as remuneration growth naturally accelerates because of the tightening labour market and the balance of power shifting from employers running the same stories of cash flow woe as their profits rise, to increasingly empowered and employees regaining their individual and collective strength.

House prices keep rising. And just a reminder. You don't need either high turnover or high lending growth for house prices or the price of anything to rise at a fast pace. So don't be fooled into thinking that just because residential real estate activity has fallen 9% in the past six months on a year ago, or that lending growth is not accelerating that the house price cycle has finished. It has a long way to go, especially as young people start creeping back out of the woodwork after running away as soon as the LVR rules became effective in October.

IF I WERE A BORROWER WHAT WOULD I DO?

I would fix three or four years at respectively 6.25% or 6.59%.

Lets see, I can fix three years at 6.25% or I can float at 6.24%. I expect that the Reserve Bank will tighten monetary policy in experimental fits and starts over the next year and a half and take floating rates up by another 2%. That means that not only would I almost save money right away by fixing, I will be even better off at the next rate move by the RB in two weeks time, and near 2% better off come the end of 2015.

The only thing which would stop me now placing a high proportion of my debt at the three year rate is if I thought that after hitting highs in a year and a half rates will then start coming down again over 2016. I see chance of that happening if one excludes a global pandemic or foot and mouth breaking out in New Zealand.

Our economic prospects in New Zealand look very good, house price pressure is building again as net immigration flows surge and young buyers get more and more determined to get a foot on the ladder. (Think about it - pent up demand from young buyers grows every day, thus placing the RB in the position where if they relax LVR rules the housing market will surge anew.) The labour market is improving strongly and wages growth will soon follow jobs growth, though people will probably get their best income boost if they take a better paying job up the road. Do it, someone has to start the wages ball rolling.

Given the current positioning of rates and where I believe they will go to, I would look to lock up as much of my debt as possible at the three year term for 6.25%, but before doing that would search to see if anyone were offering a four year rate near 6.5% and think about taking that instead. I would leave at most now just 20% of my debt floating. Why do I jump holus bolus into fixing now whereas I have previously been advocating splashing one's rate exposure across a range of terms? Because fixed rates have just been cut with the four year rate for instance going from 7.19% to 6.59% and the three year rate now 6.25% from 6.33% two and a half months ago.

What about the five year rate which has just been cut from 7.4% to 6.99%? Personally speaking, not good enough for me.

These rate declines have been driven largely by falling medium to long term interest rates in the United States due to reduced economic optimism over there. The US ten year government bond yield has fallen this week to just 2.44% from 2.54% last week and 3% at the start of the year. But also they reflect the slowdown in credit growth following LVR rules causing banks to extend their fixed rate competition fight away from the very short terms like six and eighteen months.

So now we enter some interesting territory. Our central bank is raising the cash rate but long rates are being held down by continuing worries about growth offshore, including talk of deflation in Europe as well as some forecasters across the ditch so worried about the Aussie economy post-Budget that they think the RBA might cut rates. The effectiveness of NZ monetary policy could again be on the cusp of being hampered, as happened from 2005 into late-2006.

Between the start of 2005 and late in 2006 the Reserve Bank raised the official cash rate from 5% to 7.25%. But the three year fixed housing rate moved only in a range from 6.6% to 7.5%. The five year fixed rate was near 6.6% at the start of 2005 and did not sustainably rise above 7% until October 2006. After that rates rose another 1% heading into 2008.

Why did the long term rates only take a decent kick up after late-2006? Maybe because the Australian official cash rate over that time increased by 1.75%. The US Fed funds rate went from 2.2% at the start of 2005 to 5.25% by late-2006. Also, the RB Governor back then kept stressing that our rates would not rise all that much and people should not worry too much about it. So they didn't and they kept spending, borrowing money, buying houses, and not picking big rate hikes or prolonged above average rates.

Now we are looking at a scenario where European monetary policy is likely to be eased, Japanese monetary policy will not be tightened for years, Australian monetary policy probably won't be eased but a tightening could be well over a year away, and a rate rise in the United States could also be held off until 2016.

It looks like a scenario for NZ over the coming year to a year and a half where floating and short to medium term fixed rates are pushed up by the cash rate going from 3% to 5% come the end of 2015. But long term fixed rates could move by very little. What will happen is that people will switch into the long term fixed rates and very quickly monetary policy will see it's effectiveness diminish.

What does that mean? Increased upside risk for the OCR, increased upside risk for the NZD, reduced chances of LVR rules being relaxed all that much if at all, and not as much interest rate - derived downward pressure on the housing market and overall economy as the Reserve Bank would like. They will be sweating on other central banks sending tightening hints over 2015 which push long term borrowing costs higher. If that does not happen then we could see a repeat of 2007 when the cash rate got pushed to 8.25%. This cycle's version is hard to pick but could be somewhere between 6% and 7%. Is this scenario likely? Certainly not highly probable and not our view, but worth hedging against by seeking a good long term fixed rate. So I would fix, with a three year fixed rate of 6.25%, or a four year rate if someone offered me 6.5%.

Could some of the long term fixed rates come down even further? That is possible for two reasons. The first is decreasing confidence about the US economy pushing global long term interest rates lower. The other is a specific NZ banking system factor. As people switch from floating to fixed rates bank profits fall because margins are bigger on the former than the latter. To compensate for this banks will not only seek new cost savings from existing departmental budgets, but also look to increase lending growth and if possible boost market share.

This dynamic last played out from about 2004 to 2007 when one bank aggressively cut long term fixed rates, much to the chagrin of our central bank which saw it's monetary policy effectiveness undermined. It is not possible to forecast bank marketing and pricing campaigns, but past behaviour suggests the hints this past week of mortgage competition shifting from short to long term fixed rates could continue.

	OCR	90 day bb	1 year swap	2 year	3 year	4 year	5 year	7 year
This week	3.00	3.42	3.69	3.98	4.16	4.32	4.4	4.62
Last week	3.00	3.42	3.73	3.99	4.18	4.31	4.42	4.63
4 weeks ago	3.00	3.37	3.68	4.03	4.28	4.44	4.55	4.74
3 months ago	2.50	3.2	3.52	3.88	4.17	4.38	4.56	4.85
1 year ago	2.50	2.66	2.8	3.06	3.29	3.47	3.64	3.92

NZD Loses Some Ground

The NZD has fallen slightly this past week, partly in response to some strengthening in the greenback against a Euro hit by some weaker than expected data and downbeat comments from the ECB President. The announcement by Fonterra of a reduction in their forecast payout for this year from $8.65 to $8.40 and prediction of a payout of $7.00 next season had little impact and was actually slightly better than the average expectation.

Our currency faces a couple of years of increasing support from tightening monetary policy against a backdrop of ongoing doubts about the sustainability of upturns in the major economies.

	NZD vs. USD	AUD	JPY	GBP	EUR
This week	0.85	0.92	86.5	0.508	0.625
Last week	0.857	0.927	86.9	0.507	0.626
4 weeks ago	0.861	0.926	88	0.51	0.621
3 months ago	0.832	0.931	85.2	0.499	0.608
1 year ago	0.811	0.841	81.9	0.536	0.626

For more detailed FX analysis including the 'BNZ Markets Outlook", "BNZ Strategist" "BNZ Commodities Wrap" and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

Social Crisis is Unavoidable As We Won't Vote For The Necessary Measures

Note the slight increase in focus this past week on the deleterious social effects of both the worsening shortage of houses in New Zealand and declining housing affordability. We live in a country where generally there is an unwillingness to grasp the big picture and enact huge policy changes. (No population policy debate for instance.)

In fact we strongly tend to vote for political parties which promise to maintain the status quo rather than those with a vast policy platform of reform. We vote out those who look like they are getting above themselves with too many changes.

Improving the housing situation in New Zealand and avoiding the social woe we have been warning about for a number of years now is simply beyond our willingness if not ability to tolerate. The changes in the likes of housing regulations would be huge. In fact the furore created by the list of eight factors which I published last year shows we are not going to see any sea change to the housing situation going forward. Affordability will worsen on a trend basis and only improve a tad cyclically now and then when financing costs decline in response to faltering economic growth.

If you understand the Kiwi psyche well enough to understand this then you'll also understand why we will keep favouring investment in housing assets. It's almost like one can run a watered down version of the argument "They're not making any more of it" which farmers apply to arable land. Understanding this will lead to understanding that a capital gains tax as proposed by the left leaning parties will make no difference.

Affordability will only be sharply improved if the cost of building new houses absolutely plummets. Not by 10% or 20% but 50% including the land cost. Given that surveys I was running last year and earlier this year show that more of us are happy about house prices rising than are unhappy, we're not going to vote for anyone who proposes radical solutions which reduce our accrued equity.

What will happen then? Governments and local authorities will have no choice other than to help develop a lot more social housing. Hence Labour's policy of building 10,000 state houses a year has strong merit. But they won't be able to easily do it because the builders won't be available (remember they want to restrict inflows of migrants), the cost of buying land to disperse state houses throughout existing suburbs will be too high, and they won't want to create new versions of the state house enclaves already in place in the likes of Porirua. They may instead try to boost the state housing stock by purchasing existing houses. That means more demand.

House prices keep moving upward.

The only real uncertainty here is the size of the impact which rising interest rates will have. Given the flattening of the yield curve bringing fixed rates at and probably soon below floating rates, that high financing cost scenario may not even come into play for another couple of years.

If I Were A Potential House Buyer......

I would see the same lack of reason to hold off my purchase now as I have seen since mid-2009.

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